IT 96-42
Tax Type: INCOME TAX
Issue: Investment Tax Credit

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARING DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,	)	
Petitioner	)	**No.**
v.	)	**FEIN:**
TAXPAYER	)	**Linda K. Cliffel**
Taxpayer	)	**Admin. Law Judge**

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Colleen Gartland-Kushner of Chapman and Cutler for TAXPAYER; Sean Cullinan, Special Assistant Attorney General, for the Illinois Department of Revenue.

SYNOPSIS:

This case involves TAXPAYER and its 80%-owned subsidiary, SUBSIDIARY ("SUBSIDIARY" or "Taxpayer"). On May 6, 1994, the Department of Revenue issued an assessment for income and replacement tax against the taxpayer for the years ended 12/31/90, 12/31/91 and 12/31/92 in the amount of $4,330 inclusive of tax, penalty and interest to the date of issuance.

This matter comes on before the Office of Administrative Hearings pursuant to the taxpayer's timely protest of the Notice of Deficiency dated June 2, 1994. At issue are 1) the replacement tax investment credits claimed by taxpayer; and 2) the imposition of the Section 1005 penalty.

A hearing was held and evidence was taken by way of testimony regarding the issues. On consideration of these matters, it is recommended that these issues

be resolved partially in favor of the Department and partially in favor of the taxpayer.

FINDINGS OF FACT:

1. SUBSIDIARY's facilities are located in Hoopeston, Illinois. SUBSIDIARY is in the business of mixing fertilizers in its plant and selling fertilizer, chemicals and seed to farmers. (Tr. p. 11; Dept. Ex. No. 3)

2. Taxpayer claimed the replacement tax investment on the following machinery that was disallowed by the Department:

1990
Toolbars to apply anhydrous ammonia
Ridge applicators
Fax machine

1991
Dry fertilizer buggy
Pump for the bar mixer ("Pump")
Fork lift
EPA enclosure

1992
Spray coops
EPA enclosure

(Tr. pp. 33-36)

3. Fertilizers are mixed to either the farmer's specification or according to the taxpayer's determination after taking a soil sample. (Tr. pp. 29, 45)

4. SUBSIDIARY sells dry fertilizers which the farmer may transport to his farm by using taxpayer's dry fertilizer buggy. Taxpayer does not charge for the use of the buggy. (Tr. pp. 36, 42)

5. SUBSIDIARY sells anhydrous ammonia to farmers. The anhydrous ammonia is applied to the fields by the farmer using either the taxpayer's tool bars or ridge applicator. There is no charge to the farmer for the use of the applicators. (Tr. pp. 34, 42)

6. The spray coop was used to apply chemicals or fertilizers. After the crop was in the ground and growing, the spray coop would be used to apply pesticides or fertilizer to the plants. The spray coop was always operated by a taxpayer employee and the farmer would be charged for the application. The

charge would range from 5% to 25% of the sales price of the fertilizer. (Tr. pp. 36-37, 40, 42)

7. The EPA enclosure was required by the EPA to enclose the area where the delivery trucks were loaded with liquid fertilizer so that no pollutants were released to the air. The enclosures also had floor drains so that any spills would drain into a retention pit for disposal at a later time. The auditor states in his notes that the enclosure was a building addition which is attached to a small facility which mixes chemicals. (Tr. p. 35; Dept. Ex. No. 4)

8. The pump was used to pump liquid fertilizer or anhydrous ammonia into the "mixing bowl" where it would then be mixed with whatever products were required by the sale order. (Tr. p. 36)

9. The fax machine was used to copy mix sheets which indicated the proportions of product to be included in the fertilizer, as well as for general office use. (Tr. p. 34)

10. The fork lift was used to load bulk product delivered from suppliers, as well as load dry bag chemicals on either taxpayer's equipment for delivery or onto the farmer's equipment for delivery. (Tr. pp. 35, 41)

11. The parties have stipulated that all the equipment meets the requirements of "qualified property" according to 35 **ILCS** 5/201(e)(2) with the exception of 35 ILCS 5/201(e)(2)(D).[1] (Joint Stipulation of Fact)

12. Taxpayer agrees to the disallowance of the Enterprise Zone investment credits in the Notice of Deficiency, but contests the Section 1005 penalty as it applies to this issue. (Joint Stipulation of Fact)

13. The Department agrees that the taxpayer qualifies for the additional .5% credit for increases in base employment within Illinois for 1990 and 1991 as provided in 35 **ILCS** 5/201(e)(1). (Joint Stipulation of Fact)

CONCLUSIONS OF LAW:

ISSUE #1

[1] 35 ILCS 5/201(e)(2)(D) requires that qualified property "is used in Illinois by a taxpayer who is primarily engaged in manufacturing, or in mining coal or fluorite, or in retailing"

To qualify for the replacement tax investment credit, property must 1) be tangible, whether new or used, including buildings and structural components of buildings; 2) be depreciable pursuant to Section 167 of the Internal Revenue Code, except for "3-year property" as defined in Section 168(c)(2)(A); 3) be acquired by purchase as defined in Section 179(d) of the Internal Revenue Code; 4) be used in Illinois by a taxpayer who is primarily engaged in manufacturing, or in mining coal or fluorite, or in retailing; and 5) not previously been used in Illinois in such manner and by such person as would qualify for this credit or the Enterprise Zone investment credit. 35 **ILCS** 5/201(e)(2). The parties have stipulated that the property at issue meets all of above requirements with the exception of the fourth criterion, that is, whether the property is used in manufacturing or retailing, which is the sole issue here.

There are several different types of property that are involved in this case. The first type is application equipment. Taxpayer owns certain equipment which is used by either the customer, the farmer, or an employee of the taxpayer to apply fertilizer or chemicals to the field. This category includes the toolbars, ridge applicators and spray coops. When the farmer applies it himself, there is no charge for the use of the equipment. When an employee of taxpayer uses the equipment to apply the fertilizer, taxpayer imposes a service charge.

The auditor testified that he found that the equipment used to apply fertilizer were items used in a service occupation, and therefore did not qualify for the investment credit since they weren't used in retailing. As defined in Section 201(e)(3) of the Illinois Income Tax Act, "retailing" means "the sale of tangible personal property or services rendered in conjunction with the sale of tangible consumer goods or commodities." Taxpayer testified that in no case did they provide the service of applying fertilizer or renting equipment where the farmer did not purchase the fertilizer from them.

Taxpayer also testified that the charge for applying the fertilizer ranged from 5% to 25% of the sales price of the fertilizer. According to the

regulations for the Service Occupation Tax (86 Admin. Code ch. I, Sec. 140.101(f)), if the cost price of the tangible personal property transferred as an incident to the sale of the service is less than 35% of the total gross receipts from the transaction, it is not subject to the Service Occupation Tax. In fact, the cost price of the tangible personal property in the instant case is 75% or more.

It is clear that the application of the fertilizer is incidental to the retail sale of the fertilizer. The taxpayer only offers the service of applying the fertilizer to the fields in conjunction with the sale of fertilizer. In addition, the cost of the service is minimal in relation to the total sales price. This factual situation is distinguishable from a landscaping or lawn service business in which the service component is the majority of the fee and the property transferred is incidental to the service provided. Therefore, I find that taxpayer's application equipment qualifies for the investment credit.

The second type of property, the dry fertilizer buggy, is used in transporting the product to the customer. Since taxpayer's sale of fertilizer and chemicals qualifies as "retailing," the piece of equipment which is used to transport the product to the customer will also qualify for the credit. Department Regulation Section 100.2100(c)(9) (Admin. Code ch I, Sec. 100.2100(c)(9)) states that "any services rendered in conjunction with the sale of tangible consumer goods or commodities such as uncrating, cleaning, assembling, delivery or installation, provided such services are in conjunction with a specific sale" are included in the definition of retailing (emphasis added). Therefore, the dry fertilizer buggy qualifies for the investment credit.

The third type of property is used in the plant. This includes the pump and the forklift. The pump is used to bring chemicals into the container where they are combined. "Manufacturing" is defined as

> ...the material staging and production of tangible personal property by procedures commonly regarded as manufacturing, processing, fabrication, or assembling

> which changes some existing material into new shapes, new qualities, or new combinations.
> 35 **ILCS** 5/201(e)(3).

Taxpayer's creation of the fertilizer and chemicals it retails is a manufacturing process since it changes existing material into new qualities or new combinations. Chemicals are combined to form fertilizer which has a different use than the chemicals singly. Since a product which is different at least in name and use results from the activity, it qualifies as manufacturing. The pertinent statute allows the credit for equipment used by a taxpayer who is engaged primarily in manufacturing or retailing. The pump, which is clearly used in the process of making the fertilizer, will be qualify for purposes of the investment credit.

The forklift has two functions, that is, unloading bulk product delivered to taxpayer for use in manufacturing the fertilizer and loading vehicles for delivery to the customer. In the one instance, it is used in the manufacturing process, and in the other it is used in retailing. In either case, they are qualifying uses, so that the forklift will qualify for the investment credit. (*See* Rul. Ltr. 90-0315)

The fourth type of property is the EPA enclosures. The purpose of the enclosures is to prevent pollution from escaping when the chemicals are loaded on the trucks for delivery and to trap any spillage in a reservoir for proper disposal. The enclosures were an addition to a building where chemicals were mixed. The statute provides that real property as well as personal property will qualify for the investment credit. Since the EPA enclosures are a structural component of a building which is used in the manufacturing process, the EPA enclosures will qualify for the investment credit.

The fifth type of property is the office equipment which is the fax machine. According to the testimony, the fax machine was used to receive mix sheets which indicate the proportions of chemical to be mixed for specific orders of fertilizer as well as for general office use. General office use is not a qualifying use for investment credit purposes. Regulation Section

100.2100(c)(7) (Admin. Code ch. I, Sec. 100.2100(c)(7)) requires that "property must be used in Illinois by the taxpayer exclusively in manufacturing operations, retailing, coal mining, or fluorite mining." (emphasis added) Since a portion of the equipment's use is for general office purposes, it does not qualify for the investment credit.

ISSUE #2

Taxpayer has requested an abatement of the Section 1005 penalty due to reasonable cause. Prior to January 1, 1994, Section 1005 of the Illinois Income Tax Act imposed a penalty "[i]f any amount of tax required to be shown on a return prescribed by this Act is not paid on or before the date required for filing such return...unless it is shown that such failure is due to reasonable cause."[2]

In the Notice of Deficiency, the Section 1005 penalty was imposed both on the additional tax due as a result of the disallowed investment credit and also on disallowed Enterprise Zone investment credits. Taxpayer did not contest the disallowance of the Enterprise Zone investment credits, but has protested the imposition of the penalty.

Generally, to avoid the imposition of the Section 1005 penalty, the taxpayer must show that he acted in good faith and exercised ordinary business care and prudence. *See* Treas. Reg. 1.6661-6(b). Taxpayer claimed the Enterprise Zone investment credit for equipment in six different locations. WITNESS, the Treasurer of taxpayer, testified that it was difficult to get the information necessary to make the determination as to where Enterprise Zones were located beyond the mere name of the city. Taxpayer mistakenly claimed the Enterprise Zone investment credit only for the Rockford property.

The auditor's testimony and notes indicate that it took several attempts to get the right information, and that he was not aware of a list of Enterprise Zone Administrators that is available to the general public. (Tr. pp. 22-23;

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[2] As of January 1, 1994, Section 1005 penalties are provided for under the Uniform Penalty and Interest Act. *See*, 35 **ILCS** 735/3-1 et seq.

Dept. Ex. No. 5) Taxpayer made a good faith effort to properly report the Enterprise Zone investment credit, and in fact, did properly report the credit for every location except Rockford.

As regards the investment credit issue, I find that taxpayer exercised due care in preparing its return. Since there are no definitive regulations on qualifying property for investment credit purposes, even though certain of taxpayer's property did not qualify as manufacturing or retail property, taxpayer's position was reasonable so that no penalty should be imposed. Accordingly, taxpayer's request for abatement of all Section 1005 penalties is granted.

WHEREFORE, for the reasons stated above, it is my recommendation that the Notice of Deficiency should be finalized in part and disallowed in part, as follows:

The investment credit should be allowed on:

1) the toolbars

2) ridge applicators

3) dry fertilizer buggy,

4) forklift,

5) EPA enclosures and

6) spray coops.

Further, the Notice of Deficiency should be finalized as to the disallowance of investment credit on the fax machine, the Enterprise Zone investment credits, and the adjustment to the property factor.[3]

Also, the Section 1005 penalty is abated.

Date:

_____
Linda K. Cliffel
Administrative Law Judge +

[3] Taxpayer did not protest the disallowance of the Enterprise Zone investment credits or the property factor adjustment.